

## FTfm – Hedge fund survey

# How to avoid an average hedge fund

## Survey

Since 2009 the industry has underperformed the market. But **Eric Uhlfelder and Jonathan Kanterman** have found winners

**K**ent Clark, who oversees \$20bn as chief investment officer of hedge fund strategies at Goldman Sachs Asset Management, knows a thing or two about hedge funds. But when asked recently about the current state of the industry, he quipped: “if you can find any managers with good long-term returns and moderate volatility, let me know.”

Having reviewed more than 800 funds for FTfm’s second annual survey of model hedge funds, we can attest that Mr Clark’s riposte is not far from the truth.

The nature of the trailing five-year period in which this review is focused, from July 2007 to June 2012, explains much of the difficulties.

When simply comparing the benchmark S&P 500 equity index with the average hedge fund performance reported by BarclayHedge, it is difficult to make the case for “2 and 20” managers.

The last time hedge funds outperformed the market was during the 2008 meltdown when the S&P slumped 37 per cent and hedgies limited losses to 21.6 per cent.

The 2009 rebound saw hedgies return 23.7 per cent; but the S&P climbed 26.5 per cent. In 2010, funds were up 10.9 per cent; the market was up more than 15 per cent.

In 2011, hedge funds lost 5.5 per cent while stocks inched up a little over 2 per cent. And during the first half of this year, hedge fund managers again underperformed the S&P, returning 2.3 per cent versus the index’s 9.5 per cent gain.

Based on the popular perception of hedge funds, this is not supposed to happen. But, to some, therein lies a basic truth about the industry as a whole – too many managers who do not

deserve funding bring down averages.

While there are distinct reasons why the various individual hedge fund strategies have underperformed stocks, Mr Clark hones in on the residual effects of 2008.

The financial crisis turned even the most basic investment assumptions on their heads, and Mr Clark believes many managers have simply become gun shy, arguably suffering from post-traumatic stress disorder of sorts.

All previous sell-offs in recent memory could be understood as response to identifiable phenomena: market-wide overvaluation, misplaced faith in all things technology-based, war. But 2008 was different.

“So now when markets periodically sell off because of fear generated by the eurozone debt crisis, a slowing China, or the quarterly failure of the US economy to pick up steam, many hedge fund managers have decided to steer clear of the volatility and exposure, thus missing much of the rise in stocks,” says Mr Clark.

Accordingly, he believes

## The survey: helping to uncover quality investments

Periodic hedge fund surveys highlight the best-performing funds, the largest funds, and the top-earning managers. But they fail to look behind the numbers to discern the quality of returns: their accuracy, risk, management and adherence to investment strategy. Two funds each delivering 15 per cent in one year invariably have very different profiles that inform their respective risks and ability to deliver future gains. This review is designed to help investors discern those differences.

Our selection process was premised on the belief that funds with assets between \$100m and \$500m generally outperform their larger peers. As reported by a number of surveys, this segment of the industry appears to offer superior performance by being more focused on net returns rather than asset preservation. Smaller funds can react more quickly to a wider range of mispriced opportunities without moving markets, requiring less absolute exposure than



The daily drama on the floor of the New York Stock Exchange: many hedge fund managers have steered clear of the volatility in the equity markets, missing recent gains

Bloomberg

Many managers seem to be suffering from post-traumatic stress disorder

active rotation across strategies and managers is key to realising consistent risk-adjust performance.

Another possible explanation for underperformance is the decline in hedge fund leverage. According to the Organisation for Economic Co-operation and Development, gross hedge fund leverage reached 3.9 times assets before the crisis. Citi Prime Finance reports that number has been cut nearly in half.

But it is difficult to discern whether the net impact of this ratcheting down of risk has reduced performance or minimised losses.

In a recently published book Simon Lack, a former long-time managing director at JP Morgan, paints an even more cynical picture. He contends in *The Hedge Fund Mirage* that media focus on the top managers who have done well obscures the fact that there are many mediocre managers out there, and the average fund delivers unimpressive returns relative to the market and their lofty fees. His point: do not confuse the few with the many.

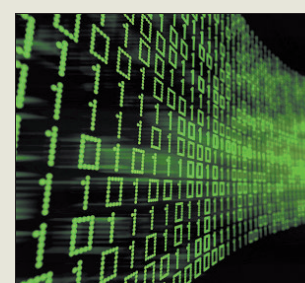
While a number of industry experts questioned his methodology, the issues he

raises are palpable. Still, assets continue to flow into the industry. According to data tracker HFR, assets hit a record \$2.19tn in the third quarter of 2012.

This makes it more essential than ever for investors who believe in the merits of hedge funds to sift through the thousands of available funds to help reduce risk and enhance the likelihood of gains.

By taking readers through the process of selecting five funds that have delivered sound performance and operations, this is precisely what we hope to have achieved through this review.

*Jonathan Kanterman is a veteran fund manager and industry consultant*



tracked by a periodical hedge fund survey.

Funds were sorted by 13 strategies and then by five-year performance. The selection process targeted five distinct strategies with managers who have been at the helm during this period and who invest a significant chunk of their own wealth in their funds. The shortlist of funds created was not determined by the best long-term returns, but rather the most consistent. Such performance tended to correlate with moderate to low volatility and a Sharpe ratio, a measure of risk-adjusted return, over 1.00, although this was not always the case. We then ran these funds through a substantial due diligence process. This

included a review of 10 key operational and performance issues. This analysis is described in more detail by searching “Due diligence: survey methodology explained” at ft.com.

We rejected a number of funds. For example, a fund with one impressive year of returns masked four average years. Several funds lacked sufficient transparency. We found a fund with attractive returns and volatility that could not square its investment strategy and targeted returns with its performance. And one of the most compelling funds we came across had survived gating and suspension – actions that normally would have precluded consideration. Lehman Brothers had been its custodian, and the fund had been unable to withdraw all assets before the bank’s insolvency. However, management did not want us to discuss this material fact, which they impressively overcame.

**Eric Uhlfelder and Jonathan Kanterman**

## What was different this year

We found only one model fund from BarclayHedge’s initial screen – the Parus long/short equity fund – so we asked the database to expand its search to include funds with assets up to \$750m. That is how we netted Vancouver-based Phillips, Hager & North Absolute Return Fund, a hybrid multi-strategy fund with C\$732m (\$734m) under management.

London-based Omni Global Macro also broke our threshold with \$538m. Its first year of operation, when it was a single separately managed account, raised an issue because these results were not independently audited. But confirming performance with the actual institutional investor enabled us to include this successful macro manager.

Still not finding enough qualifying funds, we asked BarclayHedge to screen below \$100m. Normally such small funds do not have adequate organisational structure and top-tier service providers. But that may not be the case if total firm assets under management are much larger.

LJM Partners’ Preservation and Growth Fund is one of the most consistent performing funds we have found with modest volatility and drawdown. But its assets are only \$40m. However, manager Anthony Caine, who has been running this and other options funds since 1998, has nearly \$300m under management. His scale has enabled him to operate a highly professional shop, enabling us to describe this unique Chicago-based fund. However, as is common with newer small funds when managers have a significant stake in them, performance can be enhanced by their decision not to charge themselves fees. This is less of an issue with larger funds.

The Lugano-based Talentum Emerging Alpha Fund has only \$70m in assets, but its parent Arkos Capital was also running \$769m. And this summer, GAM, the large Swiss asset manager agreed to buy Arkos, enabling us to highlight a fund that has taken the volatility out of emerging markets.

We believe these funds delineate the characteristics that advisers and investors should be looking for when seeking relatively consistent returns with moderate to low risk.

But our review does not assure or imply future performance.

The funds: following pages

# Model funds have solid infrastructure in common

## Survey

**Eric Uhlfelder and Jonathan Kanterman** outline the strategies of five very different funds

**GAM Talentum Emerging Long/Short fund** (formerly the Talentum Emerging Alpha fund)  
Strategy: Emerging market equities  
Managers: **Enrico Camera and Iain Cartmil**

Despite protracted emerging market turbulence, the GAM Talentum Emerging Long/Short fund has taken the volatility and the downside out of investing in the developing world.

The equity fund's one, three, and five-year annualised returns have been about 9 per cent. Its historical annualised standard deviation is 6.8 per cent, way below the 29 per cent of the MSCI Emerging Market Index. And the fund's worst drawdown or peak-to-trough fall, has been less than 7 per cent versus a sector average of more than 40 per cent.

This performance is one reason we decided to include this \$70.1m fund. Another was its top-tier infrastructure, which was further enhanced by the Lugano-based parent company Arkos Capital's recent decision to sell itself to GAM, the \$48bn Zurich-based global asset manager. "GAM provides a platform for much stronger asset growth," say co-fund managers Enrico Camera and Iain Cartmil. "They take care of our back office and sales, allowing us to run the fund independently, just as we've been doing."

What they have been doing is effective information mining that often gets



**Iain Cartmil (left) and Enrico Camera: carrying out effective information mining**

the fund ahead of earnings' revisions. The managers go long companies deemed to have a competitive edge and whose valuations and prospects they believe have been underestimated.

In the spring of 2011, messrs Camera and Cartmil believed analysts were not appreciating the upside that AVI, a South African consumer staples and healthcare products retailer, was likely to experience as a result of the company's new plant investments coupled with the country's rising real disposable income. Within a year, the stock had doubled.

On the short side, the fund bets against companies that are likely to be hit by competitive and macro headwinds. In the second quarter of 2011, the managers believed Brazilian insurers would see a drop in income. "The [central bank] was significantly cutting overnight rates which we felt would reduce interest income," recalls Mr Camera, "while multinationals were teaming up with local insurers, which would put pressure on premium income." The managers thought these two trends meant that 2011 consensus

expectations for industry profit growth in the mid-teens were too high. Earning growth ultimately came in closer to 10 per cent.

Volatility is limited by being focused on low market-correlated absolute returns. When the standard deviation of the fund breaches 10 per cent, the managers cut its exposure until it falls to single digits. And it will bring net exposure to zero during challenging markets.

Talentum did this to remarkable effect in 2008. The fund gained 8.7 per cent that year while the MSCI Emerging Market Index lost more than half its value.

**LJM Preservation and Growth fund**  
Strategy: Options/volatility  
Manager: **Anthony Caine**

Consistency is a key reason why LJM Preservation and Growth Fund, with only \$40m in assets, was included in this year's review. Since its inception in 2006, the fund has generated annualised returns of nearly 11.5 per cent. Its five-year annual standard deviation is 8.6 per cent, and its maximum drawdown



**Anthony Caine: mitigating significant tail risk**

is less than 11 per cent.

Manager Anthony Caine, whose LJM Partners dates back to 1998 and who also runs several other options funds with total assets of \$297m, relies on first-tier operational infrastructure we deem essential for serious investor consideration.

Another compelling factor is that, although options strategies have a history of blowing up from tail-risk events, this fund came through the global financial crisis unscathed. And as a commodity trading adviser, LJM offers daily transparency, a relatively low minimum investment of \$100,000, and monthly liquidity.

Mr Caine thinks disciplined use of S&P 500 options – guided by proprietary modelling and macro analysis – can help neutralise exposure to volatility and the index's underlying value. This then enables the fund to consistently profit from the normal decay in option pricing. He also goes long or short when he believes the market is inaccurately pricing near-term volatility.

So far, this has mitigated significant tail risk. In 2008 when the average hedge



**Stephen Rosen: his positions reflect macro theses**

fund fell more than 21 per cent and the S&P 500 slumped 37 per cent, the Preservation and Growth fund surged by more 12 per cent, falling only in October when Lehman Brothers went bankrupt.

"A key to this outperformance was that we had seen credit markets break down in 2007 – prior to the collapse in equities – and decided to establish defensive positions going into 2008," said Mr Caine.

While his strategy has excelled during difficult markets, the rub is that it often trails when stocks rally. In 2009, when the S&P was up more than 26 per cent, the fund gained only 11.1 per cent.

The reason goes to a core thesis: when markets rally more than 10 per cent in any three-month period, they are less likely to do so again over the next quarter and S&P call contracts should experience reduced volatility. However, according to Mr Caine, when markets fall, there's a greater likelihood of further decline and increased volatility. This explains why the fund is better at containing declines than in exploiting sharp upside moves.

A detailed look at performance does reveal intramonth volatility. "But", says Mr Caine, "we have found characteristics of the options market that, with timely rotation of positions, enables us to realise annual returns of 11 per cent."

**Omni Macro fund**  
Strategy: Global macro  
Managers: **Stephen Rosen and Nick Munns**

Several facts immediately distinguish this global macro fund. It has never had a down year. Annualised gains are more than 21 per cent since inception in 2007. And manager Stephen Rosen has generated these returns by making only a few discretionary trades at any one time, having just five in place at the end of June.

He does not believe in asset allocation. Diversification, to Mr Rosen, is not a substitute for due diligence and risk management. He is quick to limit a drawdown. When Omni has fallen by 3 per cent, he reduces exposure by 50 per cent.

He has made this move seven times, most recently in late 2010 when he thought the Federal Reserve's second crack at quantitative easing would give risk assets only an ephemeral lift, and again in early 2011 when he expected the re-emergence of the eurozone debt crisis to hurt stocks worse than it did. Omni ended both years up, 12 per cent and 10.5 per cent respectively.

Mr Rosen's core structural trades, typically lasting one to three months, are informed by public policy, market behaviour, interest rates, and liquidity. Nick Munns, his co-manager, adds shorter-term tactical trades that play out in less than a week.

**Continued: following page**

## Five model hedge funds

Name of fund	Start date	Fund assets (\$m)	Strategy	One-year return (%)	Three-year annualised return (%)	Five-year annualised return (%)	Annualised return since inception	Worst drawdown since inception	Annualised standard deviation over past one year	Annualised standard deviation over past five years	Average sharpe ratio past five years	Firm name	City	Country	Firm Assets (\$m)	Mgmt fee	Incentive fee
Parus Fund (C) USD	Dec-02	132	Equity long/short	8.64	14.39	14.48	17.23	15.52	19.89	15.67	0.88	Parus Finance	Paris	France	132	1.5	20
Barclay Equity Long/Short Index Average				-3.96	3.71	1.18	10.07	14.25	7.05	6.47	0.07						
Talentum Emerging Alpha Fund EUR	Feb-07	70.1	EM equities	9.90	8.78	8.71	8.51	6.96	7.41	7.1	1.12	Arkos Capital SA*	Lugano	Switzerland	769	2	20
Barclay Emerging Markets Index				-12.29	5.05	-1.43	9.57	42.51	13.76	15.5	-0.14						
LJM Partners (Preservation & Growth)	May-06	40.2	Options/volatility	11.54	10.54	12.54	11.43	10.89	12.78	8.6	1.37	LJM Partners	Chicago	US	297	2	20
Barclay Options & Volatility Trading Fund Averages				1.63	6.33	2.14	9.59	23.94	19.37	22.03	0.39						
Omni Macro Fund I	May-07	982	Global macro	13.16	13.32	21.42	21.09	14.14	7.83	14.3	1.45	Omni Partners	London	UK	538	2	20
Barclay Global Macro Index Average				-1.62	2.92	3.22	8.68	6.42	3.87	5.43	0.46						
PHN Absolute Return Fund - C\$	Oct-02	732	Multi-strategy	9.74	16.80	14.96	15.01	7.80	4.10	7.55	1.77	Royal Bank of Canada Asset Management	Vancouver	Canada	260,000	1.45	0
Barclay Multi-Strategy Index Average				-2.09	6.94	2.97	9.34	19.29	3.97	6.92	0.33						

All data is of June 30 2012

\* GAM acquired Arkos Capital at the end of July 2012

## FTfm – Hedge fund survey

## Small funds with some unorthodox approaches

Omni regulates its limited, concentrated investments and risk by trading liquid leveraged contracts. Gaining exposure in this fashion enables the fund to maintain significant cash balances. The fund does not explicitly limit leverage at the portfolio level, which typically runs about 150 per cent, occasionally reaching 275 per cent.

Foreign exchange-focused and peppered with commodity, equity indices, and interest rate exposure, Mr Rosen's positions reflect macro theses or their temporary dislocation.

For instance, in November 2010 with the restart of QE, markets feared soaring prices. As an inflation hedge, investors ploughed into precious metals. Mr Rosen agreed with the implications of capital flooding into markets, but he had not yet seen evidence of inflation.

Three-month US Treasury rates were just a few basis points and global growth was still slow.

The doubling of silver prices in early 2011, in his mind, was a result of investors becoming transfixed by a thesis.

In late April, using front futures contracts, Mr Rosen began shorting silver in several pair trades, being long gold and oil.

When he unwound the trades in late May, the fund gained 4 per cent.

**Parus Fund**  
Strategy: Equity long/short  
Managers: **Fabrice Vecchioli and Edouard Vecchioli**

Parus' managers avoid looking into the eyes of company executives. "We prefer instead to sift for evidence of disruptive innovations to help clue a position, avoiding misplaced sentiment that can come from visiting people and places," says Fabrice Vecchioli, co-manager of the \$132m fund.

This unorthodox approach may have emanated from the fund's founders having cut their teeth as fixed income specialists. Mr Vecchioli and his younger brother Edouard believed their understanding of company financials and business models would give them an edge in bottom-up stock picking.

Being market-capitalisation, sector, and geographically agnostic, the four-manager team relies exclusively on their own and independent research along with fundamental analysis to assemble a portfolio around competitive themes. Typically, two thirds of the fund's 45 positions are long and one third are short.

When the fund started, its long positions focused primarily on growth stocks and its short positions on solid companies that were deemed to be overvalued. This did not work, "so we

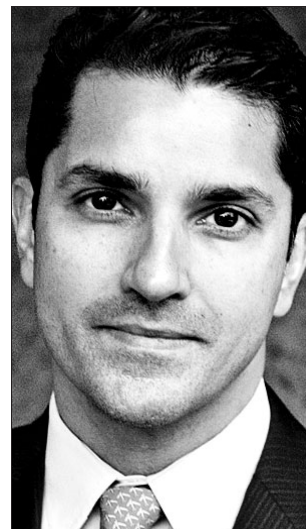


**Fabrice Vecchioli: avoids misplaced sentiment**

adjusted our strategy," explains Fabrice, "making sure our longs included growth companies with distinct competitive advantages and our shorts targeted lesser quality operations getting hit by structural issues."

This approach has served the Paris-based shop – which is presently relocating to London – very well. Since its inception in December 2002, the fund's dollar share class has generated annualised returns of more than 17 per cent.

The ride has remained a bit bumpy with trailing five-year average standard deviation of over 15 per cent. But this is primarily



**Hanif Mamdani: his fund offers daily pricing**

the result of having investment horizons of three to five years for its long positions and one to two years for shorts. And the fund's worst drawdown, 15.5 per cent, reflects the underlying soundness of the managers' ideas and their ability to reverse their positions when investment theses change.

The fund's performance when volatility has been at elevated levels is noteworthy. Between 2007 and 2009, Parus outdistanced its benchmark MSCI World stock index by an average of 25 percentage points each year.

It presciently cut its net long exposure of 70 per

cent-plus to under 30 per cent in May 2006 in response to deteriorating business specific conditions. It built a 20 per cent short position in various financial stocks, having seen the deteriorating quality of mortgage securitisations. This generated cumulative returns of 33 per cent in 2007 and 2008.

The fund resumed its long stance in October 2008, and in March 2009 it started building positions in the credit card industry. The market was projecting it as the next subprime; the managers concluded otherwise. By July, Parus had an 8.1 per cent long position in American Express, Visa, and Mastercard, which added more than 5.3 per cent to the fund's performance by the year's end.

**Phillips, Hager & North Absolute Return fund**  
Strategy: Multi-strategy  
Manager: **Hanif Mamdani**

This is an unusual fund. It offers daily pricing and liquidity. Its management fee is 1.45 per cent. It charges no performance fee and its minimum investment is C\$150,000.

In contrast with many funds that are struggling to attract and sustain capital, it has been hard closed for nearly two years to help it sustain consistent performance. Since it started in October 2002, the fund has

delivered annualised returns of 15 per cent. Trailing five-year annualised volatility is 7.6 per cent, and its worst drawdown is 7.8 per cent.

This hedge fund could be suggesting where the industry may be heading. That is a key reason why, despite having C\$732m, we decided to include it in this year's survey. The fund was established by one of Canada's oldest independent investment firms, Phillips, Hager & North, which Royal Bank of Canada bought in 2008. It then made Hanif Mamdani head of alternative investments.

The fund has generated its compelling risk-return profile by focusing on Canadian and US securities.

Two thirds of the fund's exposure is in investment and non-investment grade corporate bonds and income trusts, which Mr Mamdani believes are the most reliable sources of absolute returns. He then mixes in market neutral arbitrage and opportunistic plays in long, distressed, and event-driven investments.

Last November his team, including analysts Emil Khimji and Justin Jacobsen, uncovered six-year Goldman Sach's Canadian-dollar subordinated bonds trading 650 basis points above Canadian government bonds, despite the bank having made substantial improvements to its balance sheet.

Mr Mamdani established a 4 per cent stake, which has so far returned 18 per cent.

Several years after Loral Space and Communications led a leveraged buy-out of Telesat, a global satellite service operator, Mr Mamdani saw significant balance sheet improvement, which cut leverage as a multiple of underlying earnings nearly in half. He felt this would lead to the refinancing of 11 per cent senior notes due in 2015 on the first call date. This happened in May 2012 and produced a short-term net gain of 9.5 per cent.

The fund's equity position in Cogeco Cable, a Quebec-focused cable company, has not worked so far. Mr Mamdani thought the market's overreaction to a pending acquisition, which sliced 15 per cent off the stock, was overdone.

A further decline in the share price now makes the manager believe Cogeco may be "the cheapest cable stock in the continent". Despite being down on the trade, Mr Mamdani has bumped up exposure, making it the fund's largest holding, demonstrating he is not afraid of following his convictions.

## How last year's selected funds fared till mid 2012

Last year's model funds showed that when investors do their homework, hedge fund exposure can deliver superior returns both in relative and absolute terms. Calculated as an equally-weighted portfolio, the five funds we selected last year generated a net return of 3.19 per cent in the year to June 2012. That was nearly 6 full percentage points better than the average return of the five strategies cited. And it was more than 7.5 percentage points better than the BarclayHedge

average for all single-manager funds. This outperformance was also achieved with a lower level of risk than that exhibited by the industry at large. The average standard deviation of our five funds over the year to June was 7.65 per cent. The BarclayHedge average for all single-manager funds was 8.34 per cent for the same period.

The largest absolute outperformance was delivered by Jeff Osher's Harvest Small-Cap Partners Strategy, a long/short equity

fund with a market neutral focus that was up nearly 9 per cent, while his average peer was down nearly 4 per cent. The average hedge fund lost 4.3 per cent.

Scott Schaeffer's Steelhead Pathfinder Strategy, a convertible arbitrage fund, was up 7.29 per cent, topping his peers by more than 6 percentage points and the average fund by more than 11.5 percentage points.

Emerging market debt funds have struggled over the past 12 months, losing

2.26 per cent on average. But Paul Crean's Finisterre Sovereign Debt fund had a gain of 3.67 per cent.

Jack Doyle's Wexford Credit Opportunities Fund – which invests in distressed securities – delivered the weakest performance, losing 2.18 per cent. But the average fund return in this category lost even more: 6.54 per cent.

The macro fund on the list, Ray Bakhrumov's Forum Global Opportunities, was the other fund that lost money. Down 1.64 per cent,

the fund slightly underperformed the strategy average of -1.62 per cent.

While we are reticent to highlight such a short timeframe and are mindful of the S&P 500's gross return of 5.45 per cent over the same period, the performance of these selected funds during an especially rocky year appears to show that the search for quality can pay off, increasing returns and reducing risk.

**Eric Uhlfelder and Jonathan Kanterman**

## How did last year's hedge fund picks perform?\*

Name of fund	Fund assets (\$m)	Strategy	BarclayHedge strategy average*	One-year return (%)	Three-year annualised return (%)	Five-year annualised return (%)	Annualised return since inception	Worst drawdown since inception	Volatility** past one-year	Volatility** past five-years	Sharpe ratio past five years
Harvest Small Cap Strategy	279.0	Equity long/short	-3.96	8.8	4.54	11.26	14.87	7.37	9.44	9.43	1.15
Forum Global Opportunities fund	341.6	Global macro	-1.62	-1.64	10.43	18.82	22.24	10.03	10.99	17.9	1.39
Wexford Offs. Credit Opps Class A	104.1	Distressed securities	-6.54	-2.18	8.79	6.94	14.16	12.55	8.38	9.18	0.68
Steelhead Pathfinder fund	439.4	Convertible arbitrage	1.1	7.29	12.45	10.22	10.24	12.49	3.02	6.35	1.5
Finisterre Sovereign Debt fund	741.2	Emerging market debt	-2.26	3.67	12.68	10.58	9.66	21	6.44	9.92	0.99
<b>FTfm 5- fund average</b>				<b>3.19</b>				<b>7.65</b>			
<b>Aggregate 5- strategy average</b>				<b>-2.66</b>							
<b>BarclayHedge fund average</b>				<b>-4.32</b>				<b>8.34</b>			

\* One-year period was from 1 July 2011 to 30 June 2012. Three and five-year periods are to 30 June 2012

\*\* Annualised standard deviation, moving average over past year and past five years